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IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

DUQUESNE LIGHT COMPANY

AND

PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, INTERNATIONAL CITY MANAGEMENT ASSOCIATION, NATIONAL ASSOCIATION OF COUNTIES, AND NATIONAL LEAGUE OF CITIES AS *AMICI CURIAE* IN SUPPORT OF APPELLEES

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QUESTION PRESENTED

Whether the Takings Clause precludes a State, in setting utility rates, from implementing its policy of permitting reimbursement only of investment that is used and useful in the public service by denying recovery of costs incurred in planning cancelled nuclear plants.

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INTEREST OF THE *AMICI CURIAE*

The *amici*, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments. This case concerns electric utility ratemaking, "one of the most important of the functions traditionally associated with the police power of the States." *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Comm'n*, 461 U.S. 375, 377 (1983). Indeed, the States are responsible for 90% of the utility regulation in this coun-

try.[1] Moreover, many state and local governments and agencies are captive customers of intrastate utility monopolies.

The case arises from the cancellation of four proposed nuclear plants. Appellants were denied recovery of pre-construction planning expenses for the plants under a Pennsylvania statute that prohibits electric utilities from charging the cost of constructing or expanding their facilities to the ratepayers until "such time as the facility is used and useful in service to the public." Appellants contend that this denial effected an uncompensated taking of their property in violation of the Fifth and Fourteenth Amendments. The statute codifies Pennsylvania's longstanding ratemaking policy, similar to that in many other States, that an electric utility may not include in its rates the cost of construction work in progress until the project has been placed in public service.

Amici fear that the invalidation of this policy would strip the States of an important, time-tested regulatory tool. Such a decision could force the public to assume the cost of virtually all utility expenditures, no matter how superfluous, absolving investors of any risk of loss from the consequences of mistakes by management. Moreover, this Court would become the ultimate arbiter of ratemaking disputes, indeed the ultimate ratemaker, by sitting in review of every disallowance of every utility expense.

An electric utility company is a natural monopoly subject to regulation, but it operates as a for-profit enterprise, receiving many state-conferred benefits in exchange for providing power to the public. The right of the utility to a fair return is generally recognized to avoid what would be tantamount to confiscation of property that is used to serve the public. In this case, the utilities have not been forced to operate any property

[1] *See Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1207 (D.C. Cir. 1987) (en banc) (Mikva, J., dissenting).

in the public interest. Their expenditures for the proposed plants produced no benefit for ratepayers or for the Commonwealth because management cancelled the plants at the initial stage of planning. This Court has never suggested, much less held, that the Constitution requires reimbursement of all utility expenditures unless they are shown to be imprudent.

Amici are concerned that appellants' claims would significantly expand the takings doctrine as applied to utility rate regulation. Their contentions are radical departures from settled law and would hamstring the States in their regulatory capacity by preempting their judgment how best to balance the public interest with that of investors in regulating rates for electricity and other public services. *Amici* submit that the decision of the Pennsylvania Supreme Court is correct. Because this Court's decision will have a direct effect on matters of prime importance to *amici* and their members, *amici* submit this brief to assist the Court in its resolution of the case.[2]

STATEMENT

Amici believe that an understanding of the facts of this case is aided by a review of the method normally employed by utility regulatory commissions. State and federal regulators use a standard formula to determine the total revenues that a utility may raise through rates.[3] The formula is designed to cover legitimate operating expenses and to allow a return on the utility's rate base. Operating expenses are the current costs associated with furnishing utility service, and typically include

[2] The parties' letters of consent pursuant to Rule 36 of the Rules of the Court have been filed with the Clerk.

[3] The revenue formula may be expressed as $R = O + (V - D)r$. R is the total revenue required; O is the operating costs; $(V - D)$ is the net value of or investment in the rate base, with V representing the gross value of the tangible and intangible property and D the accrued depreciation of the tangible and reproducible property; and r is the allowed rate of return. See C. Phillips, Jr., *The Regulation of Public Utilities* 157-58 (1984).

wages, salaries, fuel, maintenance, taxes, and annual depreciation.[4]

The rate base is "the value of a utility's property used and useful in the public service minus accrued depreciation" (Phillips, *supra* n.3, at 281). It is helpful to distinguish between "the elements of value" and "the measures of value." *Id.* at 282. The elements of value may be classified in four categories: tangibles, including "'used and useful' land, buildings, and equipment (plant)"; working capital, property held for future use, and intangibles, including leaseholds and water rights; customer contributions and tax deferrals; and construction work in progress. *Ibid;* see also *id.* at 159. Not all States allow all elements to be included.[5] The measures of value, typically fair value or prudent investment, also vary from State to State.[6]

The rate base is multiplied by the rate of return to yield the net earnings, over and above operating ex-

[4] See *id.* at 158. A utility may charge other items, such as advertising, research and development, charitable contributions, and purchases from affiliated subsidiaries, to operating expenses, but these may not be fully allowed for ratemaking purposes. See *ibid.* "When an expenditure is disallowed it, in effect, is charged to a utility's stockholders rather than to its customers." *Ibid.*

[5] *Id.* at 159, 282. For example, in some jurisdictions (although not in Pennsylvania), construction work in progress is included in the rate base. See *id.* at 158-59. In jurisdictions where it is excluded, the allowance for funds used during construction is capitalized until the project is complete. See *id.* at 159. Other common exclusions are customer contributions and tax deferrals (*id.* at 282) and certain intangibles, such as franchise value, going concern value, and good will. *Id.* at 159.

[6] A recent survey of practices among regulatory commissions found that thirty-eight States and the District of Columbia use original cost or prudent investment; eleven use fair value or current value; and three consider all evidence submitted. See *id.* at 308, citing National Association of Regulatory Utility Commissioners, *1981 Annual Report on Utility and Carrier Regulation* 430-31 (1982). With one minor exception, the federal government uses original cost. See *id.* at 308 & n.80.

penses (including taxes) and depreciation. The allowed percentage is a weighted composite of the rates required to pay the interest on bonded indebtedness, dividends to preferred stockholders, and a return on the investment of common stockholders.[7]

This case grew out of two ratemaking proceedings before the Pennsylvania Public Utility Commission (PUC). In 1973, Duquesne Light Company (Duquesne) and Pennsylvania Power Company (Penn Power), as part of an interstate group of electric utility companies, decided to construct seven nuclear plants to meet the anticipated needs for electric power in Western Pennsylvania and Ohio. J.S. App. 2a-3a, 7a. Pennsylvania did not require the utilities to obtain prior PUC approval of the proposed construction; and they neither sought nor received approval of their decision to build.[8] Because Pennsylvania does not recognize construction work in progress as an operating expense, appellants planned to capitalize their costs for inclusion in the rate base once construction was complete.

[7] Each of these components yields a different rate. See *id.* at 331-32. The "equity" rate includes a "risk premium" in addition to the cost of risk-free investment, both arrived at on the basis of market factors. See, *e.g.*, J.S. App. 91c-93c; 46e-48e.

[8] In proceedings before the PUC to investigate the delays in the construction of the plants at issue here, appellants resisted the Commission's jurisdiction "[a]s to the propriety of construction and selection of fuel . . . ." J.S. App. 7h. This argument was based on findings of an administrative law judge that the Commission lacked jurisdiction over the planning and siting of electric generating units, that a utility may plan and construct without the express approval of the Commission, and that the first time that a utility must seek approval was in a rate proceeding subsequent to placing the unit in service. See *ibid.*

Most state commissions do not have the power to approve construction in advance. See Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. Pa. L. Rev. 497, 508, 532 (1984). "The decision to begin construction of a new generating plant is the utility's, at least in the first instance." *Id.* at 508.

In 1980, before obtaining a construction permit from the Nuclear Regulatory Commission, the utilities decided to cancel construction of four of the proposed nuclear plants. J.S. 4.[9] The PUC did not order the cancellation, and the utilities neither sought nor received approval of their decision to cancel construction.[10] Duquesne's share of the "pre-construction" costs amounted to $34,697,389 (J.S. App. 3a); Penn Power's equaled $9,569,665. *Id.* at 7a. In ratemaking proceedings before the PUC seeking a general increase in rates, the two utilities sought to amortize these pre-construction costs, as part of their operating expenses. *Id.* at 3a, 7a.

While the Duquesne rate case was before the PUC, the Pennsylvania Legislature amended the Public Utility Code by Act 1982-335, 66 Pa. Cons. Stat. § 1315, to provide that the "cost of construction or expansion of a facility" could not be "made a part of the rate base nor otherwise included in the rates charged by the electric utility" until the plant was "used and useful in service," which was defined as "presently providing actual utility service to the customers." *Id.* at 4a-5a.

The Administrative Law Judge (ALJ) appointed by the PUC to investigate the plant construction program, found that the utilities had acted prudently at relevant stages of the pre-construction period; he recommended that Duquesne be allowed to recover the cost of the planning for the cancelled plants by amortization over a period of ten years at the rate of $3,469,739 a year. *Id.*

[9] The project was owned primarily by three Ohio utilities, which were denied recovery of their share of the costs. *See Office of Consumers' Counsel v. PUC*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982); *Cleveland Elec. Illum. Co. v. PUC*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Cleveland Elec. Illum. Co. v. PUC*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983).

[10] "The decision to cancel a partially constructed plant . . . is also the utility's in the first instance." Pierce, *supra* n.8, at 510. It appears that even fewer States can order cancellation than can approve construction. See *ibid.*

at 4a. The PUC accepted the ALJ's report; it also interpreted Section 1315 to bar adding the costs of incomplete construction to the rate base, but not to preclude passing through those costs to the ratepayers by amortization. *Id.* at 5a-6a. The PUC granted Duquesne an overall annual revenue allowance of $802,463,063, an increase of $105,850,000 (*id.* at 126c), or 15.2%. The amortization at issue in this case thus constitutes 3.28% of the annual increase allowed by the PUC and less than ½ of 1% (.43%) of Duquesne's total annual revenue allowance. The increased revenue allowance reflected an equity return of 16.14% and an overall return of 11.64%. *Id.* at 93c.

In a separate proceeding, the PUC, relying on the ALJ's report and its own decision in the Duquesne rate case, allowed Penn Power to amortize its pre-construction costs at the rate of $956,967 for ten years. *Id.* at 7a. The PUC granted Penn Power overall revenues of $184,186,000, an increase of $15,364,000 (*id.* at 3e-4e), or 9.1%. The amortization contested here thus constitutes 6.2% of the revenue increase approved by the PUC and slightly more than ½ of 1% (.52%) of Penn Power's total annual revenue allowance. The increased revenue allowance reflected an equity return of 15.72% and an overall return of 12.02%. *Id.* at 48e.

The Office of Consumer Advocate filed petitions with the Commonwealth Court for review of the orders in both the Duquesne and Penn Power proceedings, which were consolidated on appeal. *Id.* at 8a. The Commonwealth Court held, in a four-to-three decision, that the PUC had correctly construed Section 1315. *Id.* at 8a-9a. On appeal, the Pennsylvania Supreme Court unanimously reversed on the ground that Section 1315 precluded recovery of the pre-construction expense of the cancelled plants. *Id.* at 15a. The court rejected appellants' federal constitutional challenges[11] and remanded

[11] The court rejected appellants' argument that such an interpretation would "wor[k] a confiscation of utility property without

the case to the PUC for further proceedings. *Id.* at 30a-31a.

SUMMARY OF ARGUMENT

I. Appellants' assertions of per se taking reflect a misunderstanding of this Court's decisions in the field of utility rate regulation. The criticisms voiced by Justice Brandeis, concurring in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289 (1923), persuaded the Court to repudiate the requirement that a utility receive a fair return on the "fair value" of its property devoted to the public service (*see Smyth v. Ames*, 169 U.S. 466 (1898)). When it did so, however, the Court shifted its focus from the details of the ratemaking process to its end result. Thus, in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942), the Court approved a reduction in natural gas rates, finding that the rate order, "viewed in its entirety, produce[d] no arbitrary result." In *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), the Court clarified that judicial review was confined to "the total effect of the rate order," regardless of "infirmities" in "the method employed to reach that result." Since then, the Court has repeatedly declined to mandate either a particular methodology or a particular rate, and has required only that the end result avoid confiscation.

Appellants' reliance on Justice Brandeis' *Southwestern Bell* concurrence as replacing the used and useful test by the prudent investment standard errs on two grounds. First, that standard refers only to the measure of value of property, and not to the inclusion of elements of value in the rate base. For the latter purpose, Justice Brandeis supported the used and useful test. Second, although the Court agreed with Justice Brandeis that the "fair value" standard must be rejected, it did not adopt his prudent investment standard. The Court has wisely refused to mandate any single standard for utility regulators. Prudent investment, in particular, is seriously flawed as an exclusive determinant of utility rates.

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just compensation." J.S. App. at 21a. The court also rejected Duquesne's claim that Section 1315 violated the Due Process Clause by operating retroactively, finding no contractual or vested right to recover the cost of investments that do not provide utility service. *Id.* at 26a. Finally, the court rejected an equal protection claim (*id.* at 27a-30a) and claims under the state constitution.

Appellants' asserted rights to a balancing in their favor of investor and consumer interests rests upon references in *Hope* and the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), to the investor interests that the ratemaking process should consider. In neither *Hope* nor *Permian*, however, did the Court engage in balancing; in both cases, the Court concluded its inquiry when it determined that the investor interest had been met by the establishment of nonconfiscatory rates. Here, appellants have not even alleged that their overall revenue allowance is confiscatory. Moreover, investor interests are only part of the equation; and on this record there is no reason to elevate them over those of the ratepayers and the public.

II. Appellants' per se arguments find even less support in regulatory takings cases outside the utility context. There is no physical invasion of property, nor even any physical property to invade. The facts do not meet the criteria used by the Court to evaluate regulatory takings. The overall economic impact on appellants of denying recovery of their cancellation costs is minimal, especially when compared with losses in other unsuccessful takings claims. *See, e.g., Hadacheck v. Sebastian*, 239 U.S. 394 (1915). These costs may not be isolated for takings law purposes as separate segments of property. *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1249 (1987). Nor have appellants, whose arguments depend on a world in which utility investments are risk-free, shown *reasonable* "investment-backed expectations" of recovery of the cost of the cancelled plants (*see, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979)). Finally, appellants have not identified any governmental action that took anything from them. It was not the Commonwealth of Pennsylvania but economic forces that rendered their investment worthless.

ARGUMENT

Constitutional protection for utilities in rate regulation is based on the right to a fair return on property put to public use, namely to provide utility service.[12] The theories used by this Court in reviewing the constitutionality of rate regulation have varied over time, but today there can be no doubt that the appropriate standard is whether the rate arrived at can be termed confiscatory, without regard to the methodology employed.[13]

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[12] *See Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc); *see also FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 602-03 (1942) (Black, J., concurring); see generally Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. Rev. 65, 72-79 (1985).

[13] Over time, the Court has identified both the Takings Clause (*see, e.g., Smyth v. Ames*, 169 U.S. 466, 546 (1898) ("just compensation" for the use of property beneficial to the public required), and the Due Process Clause (*see, e.g., Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938); *Natural Gas Pipeline*, 315 U.S. at 586; *see also id.* at 599 (Black, J., concurring)), as the source of the constitutional limits on rate regulation.

More recently, the Court has not explicitly named the source of the constitutional protection. *See, e.g., FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974) (referring only to "constitutional" limitations on ratemaking); *Permian Basin Area Rate Cases*, 390 U.S. 747, 768-70 (1968) (same). In *FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1113 (1987), the Court cited "traditional Fifth Amendment standards," but discussed only a taking of "private property devoted to public uses." *See also id.* at 1114 (Powell, J., concurring).

In *Pennell v. City of San Jose*, 108 S. Ct. 849 (1988), involving the related issue of rent control, the Court considered both takings and due process challenges to a requirement that tenant hardship be considered in reviewing a substantial rent increase. The majority held that the takings claim was premature (*id.* at 856), but two Justices dissented, finding that a taking had occurred (*id.* at 859). The Court, however, did reach, and rejected without dissent, the due process claim. *Id.* at 858, 859.

In this case, the questions presented are phrased in terms of takings, and appellants do no more than hint at a violation of substantive due process (Brief at 24 n.20). Although this case therefore does not require the Court to decide what difference there may be between due process and takings standards in the context of utility rate regulation, *amici* suggest that the modern view of the constitutional restrictions on rate regulation is probably better grounded in takings law. By setting rates, the government intends to allow compensation. Even if, in a particular case, the overall revenue provides insufficient compensation, the intention to pay for the public's use of utility property is still present. The Court has relied on notions of substantive due process to determine when regulation that the government does not intend to pay for "goes too far." *See Nollan v. California Coastal Comm'n*, 107 S. Ct. 3141, 3150 (1987); *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922). Moreover, in its modern application, substantive due process has little force to invalidate rate regulation. "The standard for determining whether a state price-control regulation is constitutional under the Due Process Clause is well established: 'Price control is "unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt. . . ."'" *Pennell*, 108 S. Ct. at 857 (quoting *Permian*, 390 U.S. at 769-70, quoting *Nebbia v. New York*, 291 U.S. 502, 539 (1934)).

Given the formula by which a revenue allowance is determined (see pp. 3-5, *supra*), in a particular case challenges may be leveled at exclusions from the rate base, undervaluation of property in the rate base, a low rate of return, or—as in this case—the exclusion of operating costs or other annual expenses. This Court's cases have reflected considerable controversy over what property should be included in the rate base,[14] how it should be valued,[15] and the appropriate rate of return on that value.[16]

The present case, however, raises only the question whether appellants' pre-construction expenses incurred in the initial planning stages of their ill-fated nuclear venture must be included in their revenue allowances as operating

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[14] *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605-06 (1944); *Denver Union Stock Yard*, 304 U.S. at 475-77.

[15] *Compare Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring), *with Smyth v. Ames*, 169 U.S. at 546-47.

[16] *See, e.g., Permian*, 390 U.S. at 768-70; *Hope*, 320 U.S. at 604-05; *Natural Gas Pipeline*, 315 U.S. at 584-86.

expenses.[17] This Court has resolved comparatively few disputes between utilities and their regulatory commissions over the legitimacy of operating expenses, and appellants cite none in the modern era since *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Instead, appellants and their *amici* assert in a variety of ways that Pennsylvania's refusal to permit recovery of these expenses constitutes a per se taking. These claims stand in sharp contrast to this Court's decisions, which make clear that per se takings are extremely rare. In the utility context, the modern cases exemplify a highly deferential standard based on the overall revenue allowance, which, if reasonable, will be sustained without descending into the particulars. *See Hope*, 320 U.S. at 602; *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). In other contexts, the Court has repeatedly emphasized that the takings analysis rests on an ad hoc, factual inquiry. *See, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979); *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978). Under either approach, no taking, per se or otherwise, has been shown on this record.

I. DENIAL OF RECOVERY FOR PROPERTY THAT IS NOT "USED AND USEFUL" DOES NOT EFFECT A TAKING UNDER TRADITIONAL RATE REGULATION CONCEPTS.

Appellants rely on this Court's seminal cases on utility rate regulation to attack the decision below. Because appellants' discussion of these cases seriously misconstrues their teachings, we review them briefly before turning to appellants' specific contentions.

[17] Appellants argued in the Pennsylvania Supreme Court (Brief of Duquesne below at 13, 18, 56; Brief of Penn Power below at 11, 38, 46, 47) and they still argue (Brief at 30 n.23) that they are entitled to recover these expenditures as operating expenses. We use this term even though the expenses are not those typically classified as operating expenses, *i.e.*, expenses of operating the utility to produce electricity. See n.4, *supra*.

An historical review. For many years, the controlling authority on questions of rate base and rate of return was *Smyth v. Ames*, 169 U.S. 466 (1898), which held that a utility was entitled to a "fair return" on the "fair value of the property being used by it for the convenience of the public." *Id.* at 546-47. The Court's later abandonment of the "fair value" standard is generally traced to Justice Brandeis's concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289 (1923). In its move away from the "fair value" standard, the Court did not, however, adopt the "prudent investment" standard advocated by Justice Brandeis in *Southwestern Bell*. Instead, the Court shifted its focus in reviewing utility rate regulation from the ingredients of the ratemaking process to the bottom line.

The shift began with *Natural Gas Pipeline*, a challenge to the constitutionality of the Natural Gas Act of 1938, 52 Stat. 821, 15 U.S.C. § 717 *et seq.* The Court upheld the Act's standard of "just and reasonable rates" as identical with the constitutional standard; thus the FPC could order a decrease where existing rates were not the "lowest reasonable rates." 315 U.S. at 586. In approving a rate reduction ordered by the FPC, the Court held (*ibid.*; emphasis added):

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. . . . If the Commission's order, as applied to the facts before it and *viewed in its entirety*, produces no arbitrary result, our inquiry is at an end.

Within two years, the Court would clarify that the "entirety" of the order was to be measured by the "end result"; and the fair value standard would become just one of the methodologies available to reach that end re-

sult. In *Hope*, the Court reaffirmed the conclusions reached in *Natural Gas Pipeline*, holding (320 U.S. at 602):

> It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Parallel reasoning led the Court to reject the contention that there is but one constitutional rate. Rather, rate regulation reflects a "broad zone of reasonableness," and any rate falling within that zone "cannot properly be attacked as confiscatory." *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968). When the Court dismissed for the second time the argument that there is only one just and reasonable rate, it specifically rejected a rate "based entirely on some concept of cost plus a reasonable rate of return." *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 316 (1974). In the Court's most recent case deciding a takings challenge to rate regulation, the Court held simply that "[s]o long as the rates set are not confiscatory, the Fifth Amendment does not bar their imposition." *FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1113 (1987).[18]

Although *Hope* and *Permian* did not deal with operating expenses, they did prescribe the constitutional standard for judging the sufficiency of all revenue allowances, whether the shortfall is attributed to elements

[18] *See also FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed . . . be higher than a confiscatory level."); *id.* at 392 ("whether any rate is confiscatory . . . can only be judged by 'the result reached, not the method employed' ", citing *Hope*, 320 U.S. at 602); *Baltimore & O.R.R. v. United States*, 345 U.S. 146, 148 (1953) ("So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.' ").

or measures of value in the rate base, to the rate of return, or to operating expenses.[19] That constitutional standard does not, however, as appellants insist (Brief at 19, 26-33), reject the used and useful test or mandate recovery of all prudent investment.

Given *Hope*'s holding that the Constitution does not require regulators to use any particular methodology, nothing is inconsistent with *Hope* except an insistence on a single methodology. Similarly, given *Permian*'s holding that the Constitution does not require any single rate, nothing is inconsistent with *Permian* except an insistence on a particular rate. *Hope* and *Permian* embrace a choice of methodology, and a zone of reasonable rates; they preclude nothing except a confiscatory bottom line.[20] In this case, of course, appellants have not even alleged that their overall revenue allowances are confiscatory.[21]

[19] Thus, if the exclusion of an item of operating expenses were significant enough to render the overall revenue allowance confiscatory, *Hope* and *Permian* suggest that the bottom line might have to be adjusted to a constitutionally sufficient level. Consistent with *Hope* and *Permian*, however, a reviewing court should not mandate any particular remedial approach. Operating costs or elements of the rate base that have been properly excluded by application of general principles should not be ordered back in; nor should a rate base properly valued according to standard practices be ordered revalued. *See, e.g., Jersey Central*, 810 F.2d at 1188 (authorizing FERC to choose either option or to adjust the rate of return).

[20] The D.C. Circuit has expressly rejected the contention that the used and useful test may not constitutionally be applied. *See Jersey Central*, 810 F.2d at 1187 ("The Commission is not precluded from employing 'used and useful,' or any other specific rate-setting formula"); *id.* at 1188 ("Jersey Central has mounted an ill-conceived and overly broad attack on the 'used and useful' principle") (Starr, J., concurring).

[21] Such a claim would border on the frivolous. The exclusions amounted to approximately ½ of 1% of appellants' annual revenue allowances, and their annual increases, even after the exclusions, were 14.75% for Duquesne, and 8.5% for Penn Power. In its Form 10-K filing with the Securities and Exchange Commission, for the fiscal year ending December 31, 1986, Duquesne concluded (at 15)

Rather than meet the requirements of *Hope* and *Permian* by demonstrating deficiencies of constitutional proportion in their revenue allowances, appellants urge upon this Court the startling propositions that the used and useful standard cannot be employed, that the prudent investment standard must be employed, and that any exclusion of operating expenses fails to take proper account of investors' interests.

The used and useful standard. Appellants trace their condemnation of the used and useful standard to Justice Brandeis' concurring opinion in *Southwestern Bell.* In this attempt, they fail to distinguish between what Justice Brandeis advocated and what he achieved. He clearly advocated abandoning the fair value standard; and the Court ultimately agreed. *See Hope*, 320 U.S. at 601, 605. He also advocated replacing the fair value standard with a standard of prudent investment; but in this he was not successful. *See id.* at 605-06; *see also Natural Gas Pipeline*, 315 U.S. at 606 (Black, J., concurring).[22]

Moreover, appellants' argument confuses the elements of value in the rate base and the measures of value of those elements. As a result, appellants attribute to Justice Brandeis a view that he did not advocate. The prudent investment standard is used as a measure of value of

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that the case before the Pennsylvania Supreme Court "will not have a material adverse effect on its financial position or results of operations."

[22] Even Justice Jackson, dissenting in *Hope*, agreed that the Court had not adopted the prudent investment standard.

> The Commission appears to have understood the effect of the two opinions in the *Pipeline* case to be at least authority and perhaps direction to fix natural gas rates by exclusive application of the "prudent investment" rate base theory. This has no warrant in the opinion of the Chief Justice for the Court, however, which released the Commission from subservience to "any single formula or combination of formulas" provided its order, "viewed in its entirety, produces no arbitrary result."

320 U.S. at 628, quoting *Natural Gas Pipeline*, 315 U.S. at 586.

elements in the rate base; it is not used to identify the elements that should be included in the rate base (see p. 4, *supra*). Justice Brandeis preferred prudent investment to fair value as the measure of value; he did not advocate any change in the used and useful standard, which identifies the elements of value to be included in the rate base.[23] Thus, the prudent investment standard, even if the Court had adopted it, would apply only to used and useful property.[24]

Justice Brandeis confirmed that he had no quarrel with the used and useful standard when he joined the Court's opinion in *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938). That case expressly held that the Constitution required "a reasonable rate of return upon the value of the property used, at the time it is being used, to render the services," "[b]ut [the company] is not entitled to have included any property not used and useful for that purpose." [25]

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[23] Justice Brandeis criticized, among other things, what he regarded as the unsound basis of *Smyth v. Ames'* fair value standard (262 U.S. at 290), the difficulty of setting present value (*id.* at 292), the difficulty of judicial review of present value (*id.* at 297-98), and the unfairness of the present value standard (*id.* at 306-07). None of these difficulties inhere in the used and useful standard.

[24] As to this latter point, Justice Brandeis explained: "Historical cost . . . is the amount which normally should have been paid for all the property which is usefully devoted to the public service. It is, in effect, what is termed the prudent investment." 262 U.S. at 294 n.6. *See also id.* at 290 ("so long as the specific items of property are employed by the utility, their exchange value is not of legal significance"); *id.* at 308-09 ("What is now termed the prudent investment is, in essence, the same thing as that which the court has always sought to protect in using the term present value."). *Southwestern Bell* did not involve the question what property should be included in the rate base, but only how that property should be valued (*see id.* at 282, 287).

[25] The Court's later opinions have had little or no occasion to address the question directly, but they reflect an assumption that the used and useful test may constitutionally be employed to deter-

The prudent investment standard. Appellants' insistence that the constitutional standard encompasses recovery of all prudent investment is plainly incorrect. The Court has disclaimed any particular formula or any particular rate and has specifically declined to mandate the prudent investment standard. *See, e.g., Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548, 567 (1945) (Commission is not required "to fix rates . . . on an investment after it has vanished, even if once prudently made"). The point is that not every disallowance of an expense rises to constitutional dimensions. Rather, there is a zone of reasonableness within which the overall rate, unchallenged here, may be set. *Permian*, 390 U.S. at 767; *Natural Gas Pipeline*, 315 U.S. at 585.[26]

Important reasons of comity and practicality argue against this Court's mandating any single standard for all state utility rate regulation. Such a requirement would further constitutionalize ratemaking, reducing flexibility for the States and creating docket problems for the Court.[27] States as a matter of policy use a variety of approaches in rate regulation and have devised

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mine the elements of value in the rate base. For instance, in *Natural Gas Pipeline*, the Court remarked (315 U.S. at 590): "It is only on the assumption that excess capacity is a part of the utility's equpiment used and useful in the regulated business, that it can be included as a part of the rate base on which a return may be earned." *See also Hope*, 320 U.S. at 606 n.12 (noting the statutory limitation of depreciation and amortization to property that is used and useful in service).

[26] *See, e.g., Mobil Oil Corp.*, 417 U.S. at 315 (noting the "common error . . . that certain provisions of the [rate] order can be isolated and viewed without regard to the total effect the order is designed to achieve").

[27] The era before *Hope* bears witness to the problems of a constitutional standard that requires this Court to scrutinize every ratemaking proceeding. By comparison, since *Hope* (at least until the last few years), the Court had nearly gotten out of the rate regulation business. Of course, this case concerns only operating expenses. Even prior to *Hope*, the Court had not been deeply involved in setting that component of the overall revenue allowance.

different ways to deal with the financial disaster resulting from cancellation of nuclear power generating units across the country.[28]

As the sole determinant of recovery, the prudent investment standard is particularly flawed. It may be the least economically defensible of all the regulatory approaches. It would "increase consumers' bills dramatically without producing any tangible benefit for the consumers" and would produce "results strikingly different from the results of erroneous investment decisions made by firms in unregulated markets."[29] It provides an incentive to overinvest in capital assets.[30] A regulatory process based solely on prudence would be expensive, intrusive, unpredictable, and probably futile, in part because a finding of prudent investment may reflect no more than the extraordinary difficulty of proving imprudence.[31] Nor is recovery of prudent investment in assets that are not used and useful necessary to enable the utility to attract new capital or to protect the long-term interests of existing stockholders.[32]

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[28] See, *e.g.*, Energy Information Administration, U.S. Dept. of Energy, *Nuclear Plant Cancellations: Causes, Costs, and Consequences* 33-57 (April 1983); Drobak, *supra* n.12, at 112-19; Pierce, *supra* n.8, at 517-20. Thus, it makes no difference whether "'the overwhelming weight of authority' support[s] the recovery through amortization *of* prudently incurred investment in cancelled electric generating projects." Brief for Appellants at 6, quoting the ALJ's report. This choice is a matter of policy, not constitutional imperative. Pennsylvania itself uses a number of different approaches. Since the enactment of Act 1985-62, 66 Pa. Cons. Stat. § 520, the PUC is authorized to permit recovery by amortization of prudently incurred investment in cancelled generating units.

[29] See Pierce, *supra* n.8, at 506.

[30] *See Jersey Central*, 810 F.2d at 1190 n.1, 1191 (Starr, J., concurring); Pierce, *supra* n.8, at 506-07, 559.

[31] See *id.* at 512 & n.80, 517, 538.

[32] The market in utility stocks and bonds is self-correcting. If application of the used and useful standard operates to increase

Appellants invoke "the utility's statutory duty to serve" (Brief at 29) as the basis for a constitutional requirement of recovery of prudent investment.[33] Contrary to their implication, utilities are managed not only to serve the public, but to earn profits for their investors. The utility's right to a reasonable rate of return and protected monopoly position are provided in exchange for service in a least-cost manner.[34] The so-called "regulatory compact" is plainly more complex than "we spend it, you pay for it." [35]

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the risk of disallowance, "[t]heoretically, in subsequent rate cases, this higher risk will manifest itself in a higher rate of return allowance being granted to the utility to 'compensate' for the additional risk." *New England Power Co.*, 42 FERC (CCH) ¶ 61,016, at 61,080 (Jan. 15, 1988). *Cf. Jersey Central*, 810 F.2d at 1172 (higher rate of return requested in view of disallowance of costs from the rate base).

[33] Appellants suggest (Brief at 3) that they were *required* to undertake the abortive construction, but the record supports at most a finding that they were encouraged to do so. The record also contains appellants' view that the PUC was powerless even to investigate their construction activities, much less to compel them. See n.8, *supra*.

[34] For example, the duty to serve can be fulfilled by purchase of electric power as well as building generating units. In recent years, the electric industry has had substantial excess capacity. See Pierce, *supra* n.8, at 525, 526, 527 n.177 (citing General Accounting Office Report).

[35] Moreover, if cancellation of the units at issue in this case was prudent, going ahead with the construction would likely have been either imprudent or unnecessary, or both. Regulatory commissions, in setting rates, generally disallow all costs associated with imprudent investment decisions; and return on costs resulting from investments that create excess capacity has also been precluded. See Pierce, *supra* n.8, at 511, 514-17. The effect of a rule prohibiting recovery of the costs of cancelled units is simply to impose a heightened incentive for management to cancel early. The magnitude of the incentive that States provide for prudent decisions by utility management, and the allocation of risk between the utility and the ratepayers, are clearly for legislative determination, and they do not raise constitutional questions.

Balancing of investor and consumer interests. At the outset, appellants' argument that the statutory mandate enforced by the Pennsylvania Supreme Court interfered with the PUC's exercise of its discretion in balancing investor and consumer interests can be put to one side. The PUC is a state agency, which must act within the scope of its legislative authorization. Pennsylvania's highest court has determined the correct interpretation of the applicable state law and concluded that the PUC's order rested on an incorrect interpretation.[36] The constitutionality of the state law itself plainly is not to be measured by the agency's mistaken application of it.

In any event, *Hope* and *Permian* do not support appellants' contention that the Pennsylvania Supreme Court did not properly balance investor and consumer interests. *Hope* and *Permian* do not mandate balancing any more than they require any particular ratemaking methodology or any particular rate; and this Court did not engage in any balancing in either case.

Hope indicated that "the fixing of 'just and reasonable' rates . . . involves a balancing of the investor and the consumer interests" and identified the factors relevant "from the investor or company point of view." 320 U.S. at 603. But the Court approved a reduction of rates ordered by the FPC without any balancing because "the end result in this case cannot be condemned under the Act as unjust or unreasonable from the investor or company viewpoint." *Ibid.* In *Permian*, the Court, echoing *Hope*, explained, "the [reviewing] court must determine whether the *order* may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." 390 U.S. at 792 (emphasis added).[37]

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[36] Thus, the second question presented raises no more than a question of state law.

[37] Although it is not entirely clear whether the references to balancing in *Hope* and *Permian* pertained to the essentially legisla-

Appellants argue for a balancing of investor interests as though it would elevate those interests over the ratepayers'. In fact, because the ratemaking process itself is designed to produce an allowance that will afford a reasonable return to investors after payment of expenses (*see Hope*, 320 U.S. at 603; *see also Permian*, 390 U.S. at 792), the effect of balancing will generally be to *reduce* rates in order to reflect consumer interests.[38]

Although the Court has said that investors' interests are an important part of the calculus of setting rates, they are only a part. "'[R]egulation does not insure that the business shall produce net revenues'" (*Hope*, 320 U.S. at 603, quoting *Natural Gas Pipeline*, 315 U.S. at 590), for "the obvious reason that the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business." *Natural Gas Pipeline*, 315 U.S. at 590. *See Market Street Railway*, 324 U.S. at 566.

Appellants have shown no constitutional reason why a balance must be struck so as to permit recoupment of their expenditures for the cancelled plants. Appellants may not have been at fault when they risked a substantial sum on an investment that turned out to be worthless; but clearly, neither the public nor the ratepayers were at fault.[39] They were not consulted about appellants' plans, and the cancelled plants—which never proceeded beyond the planning stage—cannot conceivably benefit them. Under these circumstances, it was hardly unreasonable for Pennsylvania to decide that the balance should be struck in favor of the ratepayers, by precluding recovery of appellants' fruitless expenditures.[40]

In sum, *Hope* and *Permian* could support appellants' takings claim only if the exclusion of their costs in connection with the cancelled nuclear plants rendered their overall revenue allowance confiscatory. Although complaining that the Pennsylvania Supreme Court did not even cite *Hope* and *Permian*,[41] appellants have not alleged

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tive task of setting the appropriate revenue allowance, or to the judicial task of determining the constitutionality of that allowance, the Court obviously did not envision a constitutional balancing requirement with respect to every ingredient of the ratemaking process. The opinions demonstrate that the Court was concerned to avoid review of the details of that process, perhaps in recollection of the complexities in which it became enmeshed in attempting to determine the fair value of property under *Smyth v. Ames*.

[38] *See Market Street Railway*, 324 U.S. at 556, 568 (financial plight of company does not entitle it to charge exploitative rates); *Natural Gas Pipeline*, 315 U.S. at 607-08 (Black, J., concurring); *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951); see also Pierce, *supra* n.8, at 506 (because the result would be a dramatic increase in electric bills without any tangible benefit, "full recovery of investment costs has no chance of emerging from the regulatory process as a solution").

[39] In *Natural Gas Pipeline Co. v. FERC*, 765 F.2d 1155, 1163 (D.C. Cir. 1985), the court upheld the denial of recovery of prudent expenditures on abandoned projects, noting: "At bottom, Natural's claim is that because it acted prudently, it cannot fairly be punished by nonrecovery of its expenses. But the problem of risk allocation in this case is not a problem of fault." *See also Jersey Central*, 810 F.2d at 1181 n.3; *Kentucky Utilities Co. v. FERC*, 760 F.2d 1321 (D.C. Cir. 1985).

[40] *See Permian*, 390 U.S. at 771, approving the FPC's determination that a "producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief"; *Market Street Railway*, 324 U.S. at 527 (due process clause "has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces").

[41] Brief for Appellants at 11. This complaint is surprising because in the Pennsylvania Supreme Court, appellants between them cited *Permian* but once (Duquesne brief below at 32), and that was only in passing. They cited *Hope* only in passing (Penn Power brief below at 49), incorrectly (Duquesne brief below at 34-35, 36, 62), or for the noncontroversial proposition that it protects against a confiscatory rate of return (*id.* at 37, 38). Appellants did not argue that the used and useful standard was inconsistent with those cases; their argument was that the used and useful concept did not apply to operating expenses. See Brief of Duquesne below at 13, 18, 56; Brief of Penn Power below at 11, 38, 46, 47.

that the disallowance would make their revenue allowances confiscatory. Without an allegation of constitutional shortfall, appellants are not even entitled to a hearing, much less to prevail, on their takings claim.

II. DENIAL OF RECOVERY OF PRE-CONSTRUCTION COSTS IS NOT A TAKING UNDER TRADITIONAL CONCEPTS OF REGULATORY TAKINGS.

Appellants seek support in land use and other regulatory takings cases outside the utility context for their claim that the "reasonable expectations" of utility investors to be "made whole on their investment" "requir[e] recovery, *per se*, of a utility's prudent investment in cancelled electric generating units" (Brief at 26). The precedent in these areas, however, affords even less basis for appellants' contentions than the decisions in the special subspecies of takings law devised for rate regulation.

Appellants argue, first, that "[r]ecovery *of* prudently incurred costs . . . is deserving of protection *per se*" (Brief at 32 n.25) because to deny it is analogous to a physical invasion of their property. The denial of recovery of costs "takes from a person something that was once physically in his possession" (*ibid.*) and therefore must be "treated under a higher standard than regulations that merely diminish the expected value of an individual's property" (*id.* at 31-32 n.25, citing, *e.g.*, *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435-38 (1982)). This argument merits no serious consideration because there is no physical property to be invaded.[42] *Cf. FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1112 (1987) (distinguishing *Loretto* on ground that statute gave no right to physical occupation of

[42] Appellants' efforts never proceeded beyond the planning stage. The plans themselves, of course, remain in appellants' possession, and, should they ever come to fruition, may then, in conjunction with the resulting facilities, be includable in the rate base.

another's property). Invasion of a mere pocketbook interest has never been per se prohibited.[43] No government action physically took anything from appellants or their investors. Whether viewed from the standpoint of the stockholders or of the utilities themselves, the investment in the cancelled plants in this case was voluntary, as was the decision to terminate the projects.

Second, appellants note (Brief at 27) that this Court has considered "whether governmental conduct interferes with 'reasonable, investment-backed expectations' in determing whether a taking has occurred," citing *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). Appellants argue, in effect, that they are constitutionally absolved from any risk of loss if an investment, prudent when made, proves to be worthless. Because appellants cite only part of the test set out in *Kaiser Aetna*, and fail to satisfy even that, their argument is insufficient.

In the regulatory takings area, the Court has repeatedly disclaimed a one-factor test or "any 'set formula' for determining when 'justice and fairness' require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons." *Kaiser Aetna*, 444 U.S. at 175 (citations and footnotes omitted). Instead, the Court has decided takings claims "by engaging

[43] The heightened protection against physical invasion is provided because "the right to exclude [others is] 'one of the most essential sticks in the bundle of rights that are commonly characterized as property.'" *Nollan v. California Coastal Comm'n*, 107 S.Ct. 3141, 3145 (1987) (citations omitted). Appellants' disappointed hopes of gain are not the kind of intangible property entailing "legal ownership" that is entitled to protection. *See Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1002 (1984). Of course, not even all regulation affecting real property interests constitutes a taking (*see, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1244 n.18, 1249-50, 1250 n.27 (1987); *Hodel v. Virginia Surf. Min. & Recl. Ass'n*, 452 U.S. 264 (1981)), not even all physical invasions. *See Florida Power*, 107 S.Ct. at 1111-13; *PruneYard Shopping Center v. Robins*, 447 U.S. 74 (1980).

in essentially ad hoc, factual inquiries that have identified several factors—such as the economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action—that have particular significance." *Ibid.*

Economic Impact. The economic impact of the denial of recovery in this case of appellants' cancellation costs fails to rise to the level of a constitutionally significant loss under this Court's cases. The Court has rejected takings claims even where the regulation has been alleged to render the property nearly worthless (*see Andrus v. Allard*, 444 U.S. 51, 64-66 (1979)), or has resulted in a measurable loss as high as 87½% of the value. *See Hadacheck v. Sebastian*, 239 U.S. 394 (1915); *see also Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926) (75% diminution).[44] In this case, the excluded costs amounted to approximately ½ of 1% of annual revenues.[45] Appellants were allowed substantial annual revenue increases (by our calculation, 14.75% for Duquesne and 8.5% for Penn Power) even after excluding the disputed expenditures, and there is no suggestion that they were compelled to operate at a loss. *Cf. Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 129, 136 (1978). It is well settled that appellants have no right to the most profitable use of their property (*see Andrus v. Allard*, 444 U.S. at 66; *Penn Central*, 438 U.S. at 125-27).

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[44] In some cases, the denial of any compensation for total loss of investment has been sustained. *See, e.g., Miller v. Schoene*, 276 U.S. 272 (1928); *Mugler v. Kansas*, 123 U.S. 623 (1887).

[45] There is no claim based on the effect of the exclusion of the costs on the value of the stock in appellants' companies. Of course, even if stock prices were adversely affected, the value of the stock would not be destroyed. The stock would retain value because of the expectation of future earnings. Moreover, as appellants themselves acknowledge (Brief at 24 n.20), the exclusion of costs in this case is a one-time occurrence. Under current Pennsylvania law, similar future costs can be recovered. 66 Pa. Cons. Stat. § 520.

Appellants describe the economic impact of the nonrecovered costs as though it could be viewed in isolation from their profitable utility business. The Court, however, has repeatedly held that the economic impact of government action is to be evaluated on the basis of the property as a whole. *See Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1248 (1987); *Andrus v. Allard*, 444 U.S. at 65-66; *Penn Central*, 438 U.S. at 130-31.[46]

Appellants' claims that the denial of recovery of costs would penalize their investors (Brief at 19) and leave them uncompensated for a risk that they did not assume (*id.* at 26-30, 33) are not supported in the record. The state supreme court explained that the used and useful standard has been the law in Pennsylvania at least since 1921 (J.S. App. 19a-20a). Thus, it is reasonable to assume, absent any evidence to the contrary, that in Pennsylvania utility revenue allowances reflect the fact that recovery of expenditures is not guaranteed. In fact, appellants' equity rates of return included risk premiums.

Reasonable investment-backed expectations. Appellants' repeated references to their investors' expectations and to the prudence of the expenditures at issue in this case ignore a crucial factor in the determination whether property interests and expectations are constitutionally protected. Not all investment-backed expectations are protected; they must be "*reasonable.*" *Kaiser Aetna*, 444 U.S. at 175 (emphasis added); *see Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005-10 (1984).

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[46] In *Keystone*, for example, the coal companies contended that Pennsylvania's Mine Subsidence Act, by preventing them from mining 27 million tons of coal that they owned, had appropriated that coal for public purposes. 107 S.Ct. at 1249. The Court refused to treat this coal as "a separate segment of property for takings law purposes." *Ibid.* Rather, it viewed these 27 million tons in the context of the companies' overall operations and financial-backed expectations. *Ibid.*

This Court has made clear that

> "[p]roperty interests . . . are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law. . . ." *Board of Regents v. Roth*, 408 U.S. 564, 577 (1972). But a mere unilateral expectation or an abstract need is not a property interest entitled to protection.

Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 161 (1980). The Pennsylvania Supreme Court's authoritative construction of state law defeats appellants' claim to a reasonable expectation of compensation for all prudently incurred expenses. "Used and useful" has long been the law in Pennsylvania; it was applied to operating costs as early as 1944 (J.S App. 24a). As appellants recognize (Brief at 8 n.10), the effect of this rule is to "prevent a utility from *ever* receiving a return *of* or *on* its investment in . . . costs" of cancelled plants.

No more could the upheaval in the nuclear industry have been a secret to appellants. These units were planned in 1973 and cancelled in January 1980. During that time, 60 nuclear plants were cancelled, the first in 1972; 1974 was the last year that more units were planned than cancelled.[47] When appellants cancelled their plants, they had not yet received an NRC permit, without which construction would not have been possible. Against this backdrop, no reasonable expectation of completing the projects, much less of recovering all the costs, could have matured.

Appellants' expectations are grounded in a constitutional right that this Court has never recognized. The Constitution simply does not guarantee recovery of expenses, no matter how prudently incurred. In fact, rate regulation may reduce the value of investments or limit the rate of return to accommodate the public interest. *See Hope Natural Gas*, 320 U.S. at 601, 603; *Natural*

[47] See *Nuclear Plant Cancellations*, *supra* n.28, at 4-5.

Gas Pipeline, 315 U.S. at 590. Appellants' only constitutionally cognizable expectation was a nonconfiscatory revenue allowance; and they make no claim that their overall revenues are constitutionally insufficient. Their vision that utility investments are risk-free is not protected because it is not reasonable.

Character of the governmental action. Perhaps the most elusive aspect of appellants' takings claim is what, if anything, Pennsylvania took from them, indeed, whether Pennsylvania did anything at all to affect their property interests.[48] Appellants decided to build nuclear plants. They then decided to cancel those plants. The former decision was likely motivated by the advantages perceived, in 1973, of nuclear power; the latter decision by the loss of those advantages. But the Commonwealth mandated neither decision and was not responsible for the loss of advantage.[49]

Nevertheless, appellants insist that the Commonwealth has "taken" something from them. It appears to be nothing other than the ability to charge consumers the costs of ill-fated, unproductive studies and planning for their failed venture. The finding of a taking absent physical invasion of real property is rare, and the Court has resisted extending the protection of the "right to exclude

[48] It may be argued that this third factor is the most important, or that it is most likely to be determinative. *See, e.g., Nollan*, 107 S.Ct. at 3145; *Hodel v. Irving*, 107 S.Ct. 2076, 2083 (1987); *Kaiser Aetna*, 444 U.S. at 179-80; *Loretto*, 458 U.S. at 442 (Blackmun, J., dissenting). It is here that the Court considers whether the government has authorized a physical invasion or only imposed regulation.

[49] The causes of the reversal in fortune of the nuclear industry have been well documented. They include the OPEC oil embargoes and the ensuing conservation efforts, inflation, and the nuclear disaster at Three Mile Island. See Brief for Appellants at 17; *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, No. 86-1970 (June 24, 1988), slip op. 4 n.5; *Jersey Central*, 810 F.2d at 1206 (Mikva, J., dissenting); *Nuclear Plant Cancellations*, *supra* n.28, at 19-21, 26; Phillips, *supra* n.3, at 18; Pierce, *supra* n.8, at 502-05.

others" beyond that context. Where the Court has found a taking, it has been because of the destruction of a protected ownership interest (*see, e.g., Hodel v. Irving*, 107 S.Ct. 2076, 2083-84 (1987); *Monsanto*, 467 U.S. at 1010-14), not justified by the police power. *See Webb's Fabulous Pharmacies*, 449 U.S. at 163-64. Here, appellants have identified no protected property right; and the public interest in price regulation is well settled. *See, e.g., Pennell v. City of San Jose*, 108 S.Ct. 849, 857-59 & nn. 6, 8 (1988).

Because appellants' nuclear investment has been rendered worthless, and the profitability of their business diminished, they seek to recover for their mistake from the government. But Pennsylvania did not destroy the value of their investment, and the "loss of future profits—unaccompanied by any physical property restriction—provides a slender reed upon which to rest a takings claim." *Andrus v. Allard*, 444 U.S. at 66.

CONCLUSION

For the foregoing reasons, the judgment of the Supreme Court of Pennsylvania should be affirmed.

Respectfully submitted,

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